Absolutely nothing in Section 13-506.1(c) supports this novel interpretation of the statute. Section 13-506.1(c) by its terms is triggered once, and only once, when the regulated company first files for approval of a plan of alternative regulation:

> "An alternative regulation plan approved under this Section shall provide, as a condition for Commission approval of the plan, that for the first 3 years the plan is in effect, basic residence rates shall be no higher than those rates in effect 180 days before the filing of the plan" (emphasis added).

Ameritech Illinois did not "file a plan' in this proceeding. It already has a plan which continues to be in effect. Even if the Commission authorizes changes in that Plan, they would constitute modifications to the existing Plan, not a new plan. Moreover, the rate cap applies only during the "first 3 years" that a plan is in effect. Ameritech Illinois' Plan has now been in effect for over seven years. Under accepted canons of statutory construction, statutory provisions are to be interpreted in light of their "plain meaning" and Section 13-506.1(c), by its terms, does not apply here. Bruso v. Alexian Brothers Hospital, 178 Ill. 2d 445, 451-52 (1977).

From a policy perspective, the interpretation advanced by CUB and the Attorney General is also unwise, because it would deprive the Commission of far more ratemaking authority than the legislature intended. By capping rates in the Residence basket for only five years in 1994 and providing for this review proceeding, the Commission clearly intended to revisit the rate cap issue. However, according to CUB and the Attorney General, the price of making any changes to the Plan in this docket is another three-year rate freeze -- whether or not the Commission believes it to be appropriate, whether or not residential network access line rates are properly priced, and whether or not competition would be harmed. This would constitute a 10-year freeze period (1994-2004). If the legislature had wanted basic residential rates to be capped for 10 years, it would have specifically required a 10-year cap. A continued rate cap is unwise as a matter of policy and it should not be adopted.

3. The Construction of the Baskets

Staff and GCI oppose consolidation of the baskets. Staff states that the Residential and Carrier baskets must continue because "competition does not exist in any meaningful sense for those services". (Staff Init. Br., p. 40). This statement is a non sequitur. All of the services in all of the baskets are classified as noncompetitive. The Company's proposal addresses the fact there are services in the Residence basket which are supported by services in other baskets, and these support flows are difficult to correct if the existing basket structure continues. (Am. Ill. Ex. 1.1, pp. 44-45). Contrary to the Attorney General's claim, correcting inter-service support flows would not "unreasonably prejudice or disadvantage" particular customer classes; rather, it would reduce existing levels of "prejudice and disadvantage". (AG Init. Br., pp. 54-55).[17]

Staff and GCI continue to complain that new calling plans should not be treated as "new services" and should be assigned to the Residence basket, rather than the Other basket to which new services are normally assigned. (Staff Init. Br., pp. 40-41; CUB Init. Br., pp. 67-68; AG Init. Br., pp. 61-62). Staff argues that calling plans are not "discretionary" because customers need calling services to make use of the network. Staff is missing the point. Basic calling services are already in the Residence basket for precisely that reason. Customers have complete

---

[17] CUB complains that consolidating the baskets would increase the "incentives for Ameritech Illinois to prematurely reclassify services as competitive", but provides no clear explanation as to why. (CUB Init. Br., p. 62). Although CUB has concocted elaborate pricing stratagems that the Company could employ, the Company has never done so to date (notwithstanding the fact that the same potential exists under the existing basket structure). They would also be easily detected by the Commission and subject to further investigation.

discretion, however, whether to substitute a calling plan for basic calling services. These plans belong in the Other basket and should remain there.

Staff's principal objective in reassigning these calling plans appears to be to require the Company to make the rate reductions associated with these revenues in the Residence basket, rather than the Other basket. (Tr. 596-98). However, residence customers benefit appropriately whichever basket they are assigned to. Moreover, as the Company explained in its Initial Brief, there is a limit to the amount of rate pressure which can or should be placed on basic rates for Bands A and B calling: they already bear the full burden of rate reductions associated with the inclusion of network access lines in this basket and this burden should not be increased by shifting discretionary calling plans -- and only calling plans -- into this basket as well.[18] (Am. Ill. Init. Br., p. 45).

CUB admits that, under its proposal, Ameritech Illinois would have been "prohibited" from offering these plans at all. (CUB Init. Br., p. 68). Ameritech Illinois is at a loss to understand who would benefit by defining "new services" in this way. The Company should be permitted to offer innovative calling plans. Ameritech Illinois recognizes that CUB objected to certain of the Company's marketing practices relative to CallPak 100 and SimpliFive; those issues were fully addressed in CUB's marketing practices complaint case. Order in Docket 00-0043, adopted January 23, 2001. As long as these plans are marketed appropriately, there is no policy reason to prohibit them and CUB made no such request in Docket 00-0043. CUB is

---

[18] Because the calling plans are based on simplified rate structures (for example, CallPak 100 offers all calls -- Bands A, B and C -- at 10¢ a call), it is difficult to change their rates without negatively impacting the simplicity component. Therefore, their inclusion in a basket generally requires larger decreases in whatever other services are in that basket. (See Tr. 577-78). Network access lines already have that same effect in the existing Residence basket; because their prices are too low and should not be reduced further, their inclusion in the Residence basket requires disproportionately large annual reductions in basic usage rates. (See also CUB Init. Br., pp. 68-69).

apparently trying to use the "new services" definition as a back-door mechanism to accomplish what it never asked the Commission to do directly. This tactic is improper and should be rejected.[19]

4. Exclusion of Certain Services

GCI opposes the exclusion of carrier access services, UNEs, wholesale services and 911 services from the price index. (CUB Init. Br., pp. 65-67; AG Init. Br., pp. 58-59; City Init. Br., p. 41; Cook County Init. Br., p. 58).[20] CUB contends that Section 13-506.1 does not authorize such exclusions. That is incorrect. The Commission excluded 911 and intraMSA toll services from the Plan in 1994 and UNEs in 1997, without an appeal from any party. It is a little late to raise legal objections at this juncture.

Furthermore, Section 13-506.1(a) provides the Commission with expansive authority to develop alternative forms of regulation; price regulation is only one example in a list of nonexclusive alternatives (".....including, but not limited to, ..."). Nothing prohibits the Commission from concluding, for example, that setting rates for a noncompetitive service at TELRIC or LRSIC, with an allocation for overhead costs, will result in "just and reasonable rates". This conclusion is required, moreover, in the case of UNE and wholesale (resale) rates;

---

19 Both CUB and the Attorney General accuse Ameritech Illinois of utilizing "Ramsey pricing" in setting the rates for CallPak 100 and SimpliFive. (CUB Init. Br., p. 68; AG Init. Br., p. 61). This is nonsense. The essence of Ramsey pricing is to produce the greatest social well-being from a system of prices that raise a specified amount of revenue over and above the incremental costs of the various products and services; generally this is translated into increasing rates on the least elastic services, because in that manner demand is least distorted. (Am. Ill. Ex. 4.2, pp. 34-35). Calling plans are, by definition, highly discretionary and, therefore, more elastic than network access lines; customers will not subscribe to them unless they conclude that they offer a better overall value than basic usage rates. Therefore, they are not inelastic services and they have not been Ramsey-priced.

20 Staff supported exclusion of UNEs from the index, but opposed exclusion of wholesale and carrier access services. (Staff Ex. 27.0, pp. 5-6). Since Staff did not raise these issues at all in its Initial Brief, the Company assumes that Staff's position has changed.

the Company is legally entitled under TA96 to charge the prices which result from the Commission's TELRIC and avoided cost pricing methodologies, respectively.

CUB and AT&T attempt to analogize their positions on all of these services to the treatment of carrier access charges when they were subject to both the Illinois and FCC price cap requirements through mirroring. (CUB Init. Br., pp. 66-67; AT&T Init. Br., p. 6). Their analogy works in the opposite direction. In practice, Ameritech Illinois' carrier access charges have been subject to only <u>one</u> pricing mechanism: since the FCC's price cap plan and other FCC rate restructuring initiatives required larger reductions than the Illinois Plan, the Illinois Plan never required any additional price changes. (Staff Init. Br., pp. 16-18). In contrast, CUB's and AT&T's proposal would apply <u>two</u> pricing mechanisms to UNEs, wholesale services and carrier access charges: they would be subject to their own pricing rules, <u>and</u> they would be subject to the annual price index. This is double-counting and should not be required. (See also Am. Ill. Init. Br., pp. 47-48).

Finally, CUB and AT&T contend that carrier customers should benefit from the service quality penalties built into the Plan. (CUB Init. Br., p. 67; AT&T Init. Br., p. 8). UNEs and wholesale (resale) services are subject to a separate service quality penalty plan, which is currently under investigation pursuant to Condition 30 of the Merger Order (Docket 01-0120). It would be duplicative for these carrier services to benefit from both service quality plans. Moreover, there is no evidence that carrier access services have experienced any service quality problems whatsoever -- they are switch-based and the Company's performance on network functions (as opposed to installation and maintenance functions) has consistently been excellent.

There is no reason why IXCs should get lower rates just because, for example, end user out-of-service conditions are not restored within the required 24 hours.[21]

5. Calculation of the API and PCI

Staff and GCI propose that the PCI and API be reinitialized (i.e., be reset to 100 from current levels). (Staff Init. Br., pp. 42-44; CUB Init. Br., pp. 71-72; AG Init. Br., p. 60; City Init. Br., p. 41; Cook County Init. Br., pp. 38-39). This recommendation is separate and apart from whether Ameritech Illinois' overall rate levels are reduced. Reinitialization would remove the "headroom" which has developed in those baskets where rates have declined more than the price index required.

This proposal primarily affects the Carrier and Business baskets. Carrier access rates in particular have fallen dramatically over the first term of the Plan. Reinitializing the API/PCI, combined with subjecting carrier access rates to the price index, would require further decreases to carrier access rates in the annual price cap filings. This is not consistent with the Commission's Order in Docket 97-0601/0602 and appropriate policy considerations, for all the reasons stated in Ameritech Illinois' Initial Brief and supra. (Am. Ill. Init. Br., p. 47-48). Mr. Koch was unable to explain during cross-examination why, as a matter of policy, the Commission should go out of its way to enrich the IXCs even further. (Tr. 592-93).

Staff and the Attorney General raise the spectre of Ameritech Illinois attempting to offset this carrier access headroom with increases in other carrier rates. (Staff Init. Br., p. 43; AG Init. Br., p. 60). However, there are no services of any consequence in the carrier basket whose rates

21 AT&T complains that they cannot sell their long distance services if the customer's line is not working. (AT&T Init. Br., p. 8). AT&T's posture is not different from that of any company which sells telecommunications-based services or uses the telecommunications network as a marketing tool: e.g., Internet service providers, voice-mail providers, pay-per-call services, mail order catalogues, aluminum siding salesmen, local contractors and charities. Aluminum siding salesmen are not entitled to monetary credits if they cannot reach a customer because the line is out of service and neither is AT&T.

could be increased: UNEs and wholesale (resale) prices are established by rate formulas that cannot be changed absent another TELRIC/wholesale (resale) pricing proceeding and the Company has made no such changes since the headroom developed in 1997.[22]

6. Monitoring and Reporting Requirements

Staff and GCI recommend that the existing reporting requirements be continued, essentially without modification. (Staff Init. Br., pp. 51-52; CUB Init. Br., pp. 15-16; AG Init. Br., p. 13). The Company agrees with Staff that the "the Commission, the Staff and the other parties with a legitimate interest in whether Ameritech is complying with its obligations under the Plan" should be provided with enough information to make an informed assessment. (Staff Init. Br., p. 52). However, existing reporting requirements far exceed what is necessary to satisfy that objective:

- Earnings-related reports have nothing to do with whether Ameritech Illinois is complying with the Plan's requirements, because the Plan does not regulate earnings;
- Information in the annual report duplicates information provided in annual price cap filing, which is submitted at the same time; and
- Information in the annual infrastructure report duplicates information required as a result of the SBC/Ameritech Merger Order. (Am. Ill. Init. Br., pp. 48-50).

[22] GCI contends that the PCI/APIs in the Plan must be reset if the Commission adopts GCI's proposal to reinitialize the Company's overall rates. (CUB Init. Br., p. 71; AG Init. Br., p. 60). Ameritech Illinois agrees that this issue would have to be addressed. However, the Company believes that it should be allowed to retain whatever headroom it earned in the Business and Carrier baskets over the first term of the Plan, as part of that process.

Unnecessary, overlapping and duplicative reporting should be eliminated to reduce the costs associated with regulation, as contemplated by Section 13-506.1(a)(1).[23]

7. One-Time Credits or Refunds

Staff proposes that two one-time credits or refunds be required as part of the Commission's final Order in this proceeding. (Staff Init. Br., p. 3). First, Staff contends that a credit or refund of approximately $29.5 million is required to correct for Ameritech Illinois' use of an "improper definition of 'regular service installation.'" Second, for the first time, Staff argues that $7.4 million should be flowed back to customers to correct for the classification of certain residential services as competitive, a classification which Ameritech Illinois voluntarily withdrew in February of this year. (Tr. 600). Neither of these proposals should be adopted.

Staff suggests that, because it disagrees with the manner in which Ameritech Illinois has defined Installation Within Five Days, Ameritech Illinois should retroactively be found to have missed that benchmark during previous years. As a result, Staff argues that the Commission should reduce Ameritech Illinois' rates by $29.5 million. (Staff Init. Br., p. 3)..

Staff's proposal is unreasonable, because Ameritech Illinois has always reported its installation data including all new ("N"), transfer ("T") and change ("C") orders, including vertical service orders which have generally been categorized as C orders. There is nothing inherently incorrect about this definition; in fact, it is the definition suggested by the language of a recent NARUC white paper on service quality measures. Most important, that is the way

[23] Staff raises several strawmen in an effort to make the Company's proposal appear unreasonable. Staff states: "Ameritech cannot suggest that it should not be required to report on service quality in light of its recent well-publicized and admitted failures in this regard". The Company never made any such suggestion. Staff states: "Ameritech cannot suggest that it should not be required to report on infrastructure investment, in light of its own commitment in its merger proceeding to continue to invest in its infrastructure". The Company never made that suggestion either. (Staff Init. Br., p. 52).

Ameritech Illinois reported the data upon which the current Alternative Regulation benchmark is based. Thus, had Ameritech Illinois reported installation performance in the manner suggested by Staff, the benchmark would not be 95.44%. (Am. Ill. Ex. 12.0, pp. 17-19).[24]

The proposal would also be unlawful. The Commission has reviewed and approved each of Ameritech Illinois' annual rate filings under the Plan, including the service quality adjustments in the Plan's PCI calculations. To impose a rate adjustment now, based upon Staff's view of the manner in which installation data should have been (but were not) reported in the past, would be fraught with both legal and policy issues, as Staff's lead policy witness pointed out:

> "In Staff's opinion, imposition of retroactive rebates or refunds to address AI's failure to maintain required service quality levels is not desirable. Apart from the legal issue of whether such reductions would constitute retroactive ratemaking, as a policy matter such retroactive adjustments should be avoided for several reasons. They may have negative effects upon efficiency incentives, and they may constitute a form of "double jeopardy" since the current plan was implemented with a given set of service quality penalties." (Staff Ex. 1.0, p. 19).

Mr. McClerren's proposal is no less retroactive simply because it would be imposed in the form of a rate reduction rather than an explicit rebate or refund. The question is simply whether Ameritech Illinois' rates were lawfully approved by the Commission. Independent Voters of Illinois v. Commerce Comm'n, 117 Ill. 2d 90, 95-98 (1987). They clearly were, and Staff's proposal to revisit annual filings now is unlawful.

Staff is simply wrong that a $7.4 million refund/credit should be required because of the reclassification of certain residential service in 19 exchanges as noncompetitive. When these

---

24 As Ameritech Illinois discussed in its Initial Brief (p. 70), Staff's and GCI's suggestion that vertical service orders would have been negligible during the benchmark years of 1990-91 are not supported by the record. The vast majority of Ameritech Illinois' vertical services were introduced between 1974 and 1989, which suggests that vertical service orders were likely quite significant by 1990, even if they may have been less significant than they are today. (See, e.g., Tr. 1790-96, 1816-19).

services were competitive, the Company made precisely the same reductions in their rates as it did in the rates of their noncompetitive counterparts. Therefore, there is no shortfall in the rate reductions that would otherwise have been required by the Plan. Moreover, these services have been incorporated in the Company's annual filing for calendar year 2000, submitted to the Commission on April 2, 2001 (administrative notice requested). Staff's proposal would require the Company to reduce rates <u>twice</u> and it is wholly improper.[25]

B. <u>New Components of the Plan</u>

Staff and GCI continue to promote their penalty plans which are designed to discourage the Company from reclassifying services as competitive. (Staff Init. Br., pp. 46-47; CUB Init. Br., pp. 73-74; AG Init. Br., pp. 64-65). However, none of them provide any legal basis for such a penalty, nor do they address the policy and equity issues raised by the Company.

GCI recommends that Dr. Selwyn's proposal for addressing merger savings be adopted. (CUB Init. Br., pp. 75-76; AG Init. Br., pp. 65-66; City Init. Br., p. 41). Dr. Selwyn suggested that the Commission require a one-time adjustment to the PCI based on the same merger savings estimates he advanced in the SBC/Ameritech Merger proceeding. If anyone is guilty of "fuzzy math", it is Dr. Selwyn, not the Company. Dr. Selwyn's calculations were fictional in the merger proceeding and they are still fictional. (Am. Ill. Ex. 3.1, p. 18-19). Since the Commission rejected Dr. Selwyn's approach in Docket 98-0555, there is no basis for adopting it here. <u>Order in Docket 98-0555</u>, adopted September 23, 1999, at p. 147.

[25] Because Staff did not make this proposal during the evidentiary phase of this proceeding, there is no evidence to which either party can cite. Therefore, the Commission may which to defer this issue to the next annual price cap filing, where a proper record can be developed.

C. REINITIALIZATION OF RATES

GCI continues to argue Ameritech Illinois' rates must be reinitialized based on a rate of return analysis of its earnings. (CUB Init. Br., pp. 76-82; AG Init. Br., pp. 66-69; City Init. Br., pp. 40-41; Cook County Init. Br., pp. 39-41). GCI's position is essentially a rehash of the arguments they made in connection with what constitutes "fair, just and reasonable" rates. Ameritech Illinois has responded to most of those arguments in its Initial Brief and supra. (Am. Ill. Init. Br., pp. 53-58).

CUB claims that the Commission is legally obligated to reinitialize the Company's rates because it did so in 1994 when the Plan was adopted. (CUB Init. Br., pp. 78-79). CUB is incorrect. In 1994, the Commission reasonably concluded that a rate of return analysis was appropriate to establish the starting point for a new plan. After that, however, the Commission clearly stated that "....the price index will continue to produce reasonable rates....". 1994 Order at p. 186 (emphasis added).

GCI apparently believes that earnings are the litmus test of reasonable rates, now and forever, no matter what plan of regulation the Commission adopts. This is essentially a variant on CUB's argument to the Appellate Court on appeal of the 1994 Order that any system of regulation must continue to regulate earnings. The Appellate Court rejected CUB's argument out of hand:

> "...CUB asserts, without support, that the original purpose of the Act was to protect 'the public from public utilities charging rates that produce excess profits.' CUB argues that Section 13-506.1 'subverts' this original purpose.
>
> Assuming *arguendo* that CUB is correct about the purpose of the Act and its 'subversion' by Section 13-506.1, this does not render Section 13-506.1 beyond the state's police power...The police power provides the authority to legislate for the public good; it does not specifically define the public good or the manner in which the legislature should act pursuant to the police power. The police power, therefore, does not mandate legislation

to prevent excess profits." Illinois Bell Telephone Company v. Illinois Commerce Commission, 283 Ill. App. 3d 188, 202 (2d Dist. 1996) (emphasis added).

Finally, GCI contends that any earnings review should extend to both competitive and noncompetitive services, not just the noncompetitive services which are subject to the Plan. (CUB Init. Br., pp. 81-82). CUB continues to ignore the fact that this docket was not established to review Ameritech Illinois' competitive rates. (Am. Ill. Init. Br., pp. 22-25). The Company is not contending, as CUB implies, that its competitive services are "deregulated". Rather, they fall outside the scope of this proceeding.

GCI's theory of this case also bears no relationship to the rate changes it proposes. Although GCI constantly references rate increases on competitive services and high competitive service earnings in support of rate reinitialization, approximately 60% of the $869 million rate reduction for which it provided rate design recommendations is directed at noncompetitive services. (GCI Ex. 3.5, p. 1). If GCI is primarily objecting to competitive service earnings, it makes absolutely no sense to reduce the "going in" rates of noncompetitive services. The only evidence in the record demonstrates that they are low, even under GCI's theory of this case.

D. Earnings Sharing

The Company and Staff oppose the inclusion of earnings sharing in the Plan on a going-forward basis. (Am. Ill. Init. Br., pp. 58-61; Staff Init. Br., pp. 49-50).

CUB claims that earnings sharing is necessary because the Company's earnings levels prove that the annual rate reductions under the index have been "grossly insufficient". (CUB Init. Br., p. 83). This is patently untrue. As the Company has explained at length, the X factor was, if anything, too high and this evidence is undisputed in the record. Furthermore, under Section 13-506.1 of the Act, an earnings sharing requirement can only be applied to noncompetitive services, a limitation which CUB ignores altogether. Given the extremely low earnings on Ameritech Illinois' noncompetitive services, there is no likelihood that sharing would result under any scenario. (Am. Ill. Ex. 1.3, pp. 61-62).

GCI also claims that earnings sharing would lessen Ameritech Illinois' incentives to inflate earnings through cost-cutting measures that harm customers. (CUB Init. Br., p. 83; AG Init. Br., pp. 69-70). The Company assumes that CUB is referencing service quality issues. There is no evidence in this record that Ameritech Illinois intentionally cut costs associated with the provision of service to inflate its earnings. As explained supra, the loss of installation and maintenance personnel in 1999 had nothing to do with any Company initiatives. Moreover, there is no economic evidence to support the theory that either earnings sharing or rate of return regulation lead to higher quality service. (Am. Ill. Ex. 4.2, p. 17). In fact, earnings sharing would make it more difficult to respond to and correct service problems when they do arise. (Am. Ill. Ex. 1.4, pp. 56-57).

The other rationales offered by CUB and the Attorney General to support earnings sharing do not withstand scrutiny. (CUB Init. Br., p. 84; AG Init. Br., p. 70). The price index was not set "incorrectly" in the past and is not likely to be set incorrectly in the future; Ameritech Illinois is properly subject to both positive and negative "unexpected economic conditions"; competitive classifications are not properly at issue in this proceeding; and, as previously discussed, the Company's marketing of SimpliFive and CallPak had nothing to do with its earnings levels, because they reduced the Company's revenues.

E. RATE OF RETURN REGULATION

GCI argues that rate of return regulation is a reasonable alternative. (CUB Init. Br., pp. 87-88; AG Init. Br., pp. 71-73). GCI ignores all of the policy considerations which led the

Commission to adopt price regulation in 1994. Rate of return regulation is not a viable option in today's marketplace and it should not be pursued. Although GCI contends that rate of return is not antiquated and dysfunctional, there is virtually no support for its view in the regulatory community at large. (Am. Ill. Ex. 4.2, pp. 6-7; Am. Ill. Ex. 1.3, pp. 64-65).

IV. SERVICE QUALITY - GOING FORWARD

A. LEGAL STANDARD

As Ameritech Illinois explained in its Initial Brief (pp. 62-64), in Docket 92-0448, Staff, intervenors and ultimately the Commission itself took the position that Section 13-506.1 is directed toward maintaining, not improving, service quality. Staff and GCI now take the opposite position. (See, e.g., Staff Init. Br., pp. 53-55; CUB Init. Br., pp. 88-89; AG Init Br., p. 73).

Staff argues that Section 13-506.1(b)'s prefatory words "at a minimum" allow the Commission to require improvements in service quality. (Staff Init. Br., pp. 53-55). Section 13-506.1(b) does not support Staff's position. The phrase "at a minimum" applies to the seven mandatory statutory standards in aggregate. This phrase distinguishes the mandatory standards in Section 13-506.1(b) from the policy goals in Section 13-506.1(a), which do not have to be the subject of affirmative findings. (The Commission need only "consider" whether the Plan satisfies those goals.) That is, any alternative regulatory plan must, at a minimum, satisfy the seven mandatory standards and may, but is not required to, satisfy the twelve policy goals in Section 13-506.1(a) and Section 13-303. Section 13-506.1(b) does not provide that "maintenance" is the "minimum" standard applicable to service quality. 220 ILCS 5/13-506.1(a)(b).

The GCI parties take a different approach to this issue. They appear to read the statutory "at a minimum" language in the same way Ameritech Illinois does. However, they contend that "other" criteria, such as the public interest standard, allow the Commission to adopt service quality benchmarks aimed at improving service. (CUB Init. Br., pp. 88-89; AG Init. Br., p. 73). That argument should also be rejected. It makes no sense to read the statute as adopting a standard of "maintaining" service under one provision, while at the same time permitting requirements to "improve" service under another. Such a reading would render the express language of Section 13.506.1(b) meaningless.

And, while it is true that the Commission's 1994 construction of Section 13-506.1(b) relative to "maintaining" service quality arose in a slightly different context (Staff Ex. 15.0, p. 3; GCI Ex. 2.0, p. 26), the meaning of the word "maintain" has not changed in the intervening six years. The Commission's holding in the <u>1994 Order</u> that "maintain" did not mean "improve" was not a finding of fact or a policy determination. It was the Commission's construction of the Act. The law has <u>not</u> changed.

b. <u>Measures and Benchmarks</u>

Ameritech Illinois addressed service quality measures and benchmarks at length in its Initial Brief (pp. 64-84). Staff's and GCI's Initial Briefs have raised only a few additional issues.

First, some of the GCI parties continue to argue that their proposed service quality measures are existing measures and that their proposed benchmarks reflect historical performance levels. For example, CUB claims, "All of the measures proposed are already monitored and specifically tracked in reports filed with the FCC or as part of its merger obligations [or] within the NARUC Service Quality Reports. . . . Further . . . the benchmarks incorporated in the measures are reasonable and approximate IBT's historical performance where such information is available." (CUB Init. Br., pp. 91-92; see also id., p. 96; AG Init. Br., p. 75). Those claims are incorrect. In fact, Ms. TerKeurst defined most of GCI's proposed service quality measures and benchmarks in ways that render the existing measures and data completely inapplicable. The redefined measures include Installation Within Five Days, OOS>24, Missed Installation Commitments, Missed Installation Appointments, Missed Repair Commitments, Missed Repair Appointments, POTS Mean Installation Interval, POTS Mean Time To Repair, and POTS Installation Repeat Trouble Reports. (Am. Ill. Init. Br., pp. 66-67, 80-84; Am. Ill. Ex. 12.0, pp. 37-36; Am. Ill. Ex. 12.1, pp. 25-31).

CUB and the Attorney General also argue that Ameritech Illinois' OOS>24 reporting excludes weekends. (CUB Init. Br., pp. 44, 96; AG Init. Br., p. 79). This allegation is clearly false. Mr. Hudzik addressed it directly in his rebuttal testimony: "Ameritech Illinois does not exclude weekends or holidays." (Am. Ill. Ex. 12.0, p. 43).

Staff criticizes Ameritech Illinois' approach to calculating benchmarks because, Staff claims, Ameritech Illinois has included performance for the year 2000 in its calculations. (Staff Init. Br., p. 72). This claim, too, is clearly incorrect. Ameritech Illinois agreed, in its surrebuttal testimony, that it would remove 2000 data from its benchmark calculations, and the benchmarks Ameritech Illinois proposes do not include that data. Am. Ill. Ex. 3.4, pp. 14-16).

Finally, Staff recommend a new measure and benchmark including both installation repeat troubles and repair repeat troubles. (Staff Br., pp. 71, 137). Staff's witness, Ms. Jackson, had proposed a single measure for repeat repairs, which she identified as troubles "within 30 days" of previous trouble. (Staff Ex. 9.0, p. 22; Staff Ex. 23.0, p. 29). As Mr. Hudzik explained, that is the repair repeat trouble rate. (Am. Ill. Ex. 12.0 p. 30). Installation repeats are captured by an entirely separate measure, which tracks trouble reports within seven days (not 30) of installation. (See GCI Ex. 2.0 pp. 52-53).

A repeat installation trouble rate should not be adopted, for the reasons set forth in Ameritech Illinois' Initial Brief (pp. 83-84). (Am. Ill. Ex. 12.0, p.45; Am. Ill. Ex. 12.1, pp. 39-40). However, if such a measure were adopted the applicable penalty should be split between installation and repeat troubles, consistent with Staff's proposal for a single benchmark. For installation repeats, Ameritech Illinois proposes a benchmark of 16.90%, based on data from 1996-99.[26] (See GCI Ex. 2.0). The Commission should not adopt the benchmark suggested by GCI for installation repeat reports. That benchmark reflects an entirely different measure, New Circuits Failed, which is clearly separate and distinct from the installation repeat rate. (GCI Ex. 2.2 ("Network Scorecard")).

Staff and Ameritech Illinois agree that any new benchmarks should be phased in. Staff proposes to set each new benchmark three percentage points above the relevant benchmark, with a one-percent reduction every six months. (Staff Init. Br., p. 73). Staff's proposed 18-month phase-in is too short to accommodate the necessary planning and budgeting. (Am. Ill. Ex. 12.0, pp. 29-30; Am. Ill. Ex. 12.1, pp. 16-17). Changing the benchmarks every six months is also inconsistent with the annual filing cycle for the Plan, which could cause interpretation and administrative problems for the Commission. Therefore, the Commission should adopt Ameritech Illinois' proposal for a three-year phase-in.

[26] If Staff's benchmark calculation methodology were adopted, the necessary monthly data for installation repeat reports for 1998-99 could be provided through a post-record data request. The data are not currently in the record.

c. Penalty Structure

Staff's and GCI's primary proposals call for service quality to be removed from the price cap index, with penalties imposed in the form of customer credits, rather than revenue reductions. Staff proposes that customer-specific credits be applied to customers affected by installation and repair delays and missed installation and repair commitments. For Staff's other six proposed benchmarks, Staff proposes that credits of $2.25 per month be provided to all customers, whether they have been affected by service quality problems or not, for any month in which the benchmarks are missed. (Staff Br., pp. 73-79). GCI proposes annual penalties of $14 million for each benchmark missed, which would be escalated according to the severity of the miss and would be multiplied by 1.5 for each consecutive year in which any benchmark is missed. In addition to the annual penalties, GCI propose customer-specific credits for installation and repair delays and missed installation and repair commitments. (See, e.g., CUB Init. Br., pp. 83-85).

In principle, Ameritech Illinois does not oppose removing service quality from the price index calculation, nor does Ameritech Illinois oppose customer-specific credits, to the extent the Company's records are sufficient to determine which customers have been affected by service problems. However, certain aspects of both Staff's and GCI's proposals for addressing service quality outside the price index render those proposals unreasonable and punitive, so they should not be adopted.

Staff's Proposed Monthly Penalties. The primary problem with Staff's proposal is the imposition of very large ($14 million) monthly penalties for missing any of six of Staff's proposed benchmarks. This proposal simply makes no sense in light of Staff's own testimony. Ms. Jackson testified that the Plan's existing penalty--a .25% rate reduction for each miss--has been sufficient to maintain service quality for those objectives and should not be changed, at least if service quality remains a part of the price index calculation. She also testified that the same penalty should be presumed sufficient for new benchmarks, again assuming that service quality remains within the price index. (Staff Ex. 9.0, p. 45). She is clearly correct, as no party has suggested that Ameritech Illinois failed to meet any of the existing benchmarks other than OOS>24 and Installation Within Five Days. Moreover, as Ms. Jackson testified, there is no basis upon which to presume that greater penalties should be imposed for any new benchmarks. (Id.). Nevertheless, Staff's proposal would, in effect, multiply the penalty by 40 times, for the same measures with respect to which Ms. Jackson testified the existing penalties should remain the same. (Am. Ill. Ex. 12.1, pp. 33-34).

The lack of proportionality between Staff's proposals inside and outside the price index is, by itself, strong evidence that Staff's "outside the cap" proposal is unreasonable. Ameritech Illinois and the GCI agree that the financial impact of the Plan's service quality component should be approximately equal, whether service quality is addressed inside or outside the price index. (Compare AG Init. Br., pp. 86-87; CUB Init. Br., p. 103 with Am. Ill. Ex. 3.4, pp. 3-4, 6-7). Thus, while there are certain differences between the financial impact of rate reductions within the price cap and the impact of one-time customer credits, those differences do not explain the difference between Staff's alternative proposals. (Am. Ill Ex. 3.4, pp. 3-4,6-7). Staff's only explanation for the difference is that the resulting credits, if reduced to an amount equivalent to the current penalties, would not be "meaningful" to customers. (See Staff Ex. 23, pp. 9-10; Staff Br. at 79-80). However, as both Staff and the GCI argue, the key question is not whether the penalty is "meaningful" to customers, it is whether the penalty is adequate to maintain performance at an appropriate level. (See, e.g., Staff Init. Br., pp. 68-69, 79; Staff Ex.

9.0, pp. 42-43; AG Init. Br., pp. 84-86; Cook County Init. Br., pp. 63-64; City Init. Br., pp. 30-32, 44-45; CUB Init. Br., pp. 101-03; GCI Ex. 2.0, pp. 66-68). As Ms. TerKeurst testified, the goal should be to "determine and establish financial consequences that are sufficient to ensure that Ameritech Illinois complies with the adopted standards." (GCI Ex. 2.0, p. 67). In fact, the existing Plan uses a "pure" incentive mechanism; it contains <u>no</u> customer-specific remedies. (Am. Ill. Ex. 3.4, pp. 9-10).

Staff's use of <u>monthly</u> penalties based on <u>annual</u> benchmarks also contributes to the enormous financial consequences of Staff's proposal, and it is also deeply flawed. The Commission's existing benchmarks (and both Staff's and Ameritech Illinois' proposed benchmarks) are based on year-round historical performance. The service quality witnesses for Staff, GCI and Ameritech Illinois have all testified that such benchmarks are properly used to evaluate annual, not monthly, performance.

Mr. Hudzik testified, "All of the proposed performance measure vary significantly from month to month—even when overall perform is excellent—and most of them exhibit considerable seasonal variation. By applying monthly penalties to annual measures, Ms. Jackson's proposal guarantees that Ameritech Illinois would be required to issue unprecedented customer credits, even if service quality were maintained at established levels." (Am. Ill. Ex. 12.0, p. 36). Thus, as Ms. TerKeurst testified in Docket 92-0448, "any service quality adjustment would be based on yearly averages rather than the monthly reports." (Am. Ill. TerKeurst Cross Ex. 45, p. 51). Indeed, Ms. Jackson admitted that monthly penalties are fundamentally inconsistent with her methodology for determining service quality benchmarks.

> Q. Isn't the basic rationale underlying the methodology that you're applying in this case specifically intended to produce benchmarks for annual performance rather than monthly performance; isn't that true?
>
> A. Yes. (Tr. 2055).

GCI's Proposed Penalty Structure. GCI's penalty proposal is also unreasonable and punitive. This is a result of a combination of factors: the large number of proposed measures, the extreme stringency of many of the proposed measures, a major increase in base penalties (even for benchmarks that Ameritech Illinois has never missed), a "severity" escalation factor and, perhaps most importantly, a "multiplier" that would increase penalties whenever any benchmarks were missed in consecutive years (even when the misses were for completely unrelated benchmarks). As a result, even if Ameritech Illinois provided excellent service, it would pay hundreds of millions of dollars in service quality penalties. (Am. Ill. Ex. 12.1, pp. 40-43 & Ex. 12.12-12.14).

GCI's proposal to increase base penalties fivefold, to approximately $12 million annually per miss, is inappropriate, largely for the same reason explained above for Staff's proposal. All parties agree that a service quality penalty should be large enough to motivate the Company to comply with the relevant standard. Putting aside issues regarding OOS>24 and Installation Within Five Days, the existing penalties have clearly been sufficient for that purpose, and there is also no reason to assume that similar penalties would not be sufficient for any new benchmarks. (Staff Ex. 9.0, p. 45; Am. Ill. Ex. 12.1, pp. 33-34). Thus, based on GCI's own rationale, the existing penalties are sufficient for all measures other than 00S>24 and Installation Within Five Days.[27]

[27] Ameritech Illinois addressed proposals to increase base penalties for 00S>24 and Installation Within Five Days in its Initial Brief (pp. 85-86). Briefly, Ameritech Illinois' conduct since the $30 million merger penalty was imposed—both in terms of hiring and in terms of performance—makes clear that the additional penalty has gotten Ameritech Illinois' attention. For Installation Within Five Days, Ameritech Illinois has never missed the existing benchmark. If the Commission wishes to redefine the measure and reset the benchmark appropriately, Ameritech Illinois would not object. However, Ameritech Illinois has done nothing to deserve punishment in the form of an increased penalty.

The proposed penalties would be increased still further by GCI's proposed "severity" escalation factors. This is particularly troublesome in light of the extremely stringent benchmarks suggested by GCI. That combination would result in escalated penalties, even for excellent performance. For example, in 1999, Ameritech Illinois' performance for Missed Repair Commitments was 6.35%. That was the Company's best performance for the six years for which data are available (1995-2000). (GCI Ex. 2.1). However, if Ameritech Illinois performed at that level, under the GCI's proposal, it would pay a first-year penalty of more than $44 million for that measure alone. Similarly, first-year penalties for GCI's other proposed measures for missed appointments would range from $41 million to $60 million, even assuming good performance. (Am. Ill. Ex. 12.12).

Worse, GCI's proposed multiplier for misses in consecutive years would compound the financial impact of their proposal, pushing the penalties to unconscionable levels within only a few years. This would be true even if the Company missed completely unrelated benchmarks. For example, even if one assumed a level of performance that is very likely impossible—missing only one of the GCI's benchmarks by only one percent each year—the Company would be penalized $12 million in the first year, $61 million in the fifth year, and $159 over five years. (Am. Ill. Ex. 12.1, p. 42 & Ex. 12.14). Assuming 1999 performance (which was excellent, not only for the current measures but also for the great majority of GCI's proposed new measures), the first-year penalty would be $288 million, which would grow to $1.459 billion by the fifth year, totaling $3.800 billion for five years. (Id.). Thus, the compounding effect of the multiplier would result in enormous penalties, no matter how well Ameritech Illinois performed.

Customer-Specific Credits. Ameritech Illinois does not object in principle to addressing service quality through customer-specific credits, if service quality is removed from the price index calculation. (Am. Ill. Ex. 12.0 pp. 31-34). However, Ameritech Illinois does object to certain aspects of Staff's and GCI's customer-specific credit proposals.

GCI (but not Staff) proposes customer-specific credits for installation and repair delays and for missed installation and repair appointments, in addition to the service quality penalties that would be paid to all customers for missing annual performance benchmarks. (E.g., CUB Init. Br., pp. 103-05). This would be inappropriate. While Ameritech Illinois does not object to the idea of flowing service quality incentives back to affected customers, customer compensation per se is not the goal of an Alternative Regulation Plan. Instead, as GCI recognizes, that goal is to provide the level of incentive necessary to maintain service quality at an appropriate "going in" level. (CUB Init. Br., pp. 101-03; GCI Ex. 2.0, pp. 66-68). Assuming the Commission's penalties are adequate, providing additional compensation would be both punitive and bad policy. (See Staff Ex. 1.0, p. 19).

Both Staff and GCI would impose customer-specific credits regardless of whether the Company met the service quality benchmarks in the Plan. This is also inappropriate. In Staff's case, the proposal is inconsistent with Ms. Jackson's direct testimony, in which she recognized that credits should be tied to benchmark performance. (Staff Ex. 9.0, p. 32). It is also inconsistent with the entire concept of maintaining service at benchmark levels. If all customers receive credits regardless of service levels, benchmarks are meaningless. (Am. Ill. Ex. 12.1, p. 38). And, finally, requiring credits regardless of performance levels, in effect, is equivalent to requiring perfect performance. That is inconsistent with the Public Utility Act, which requires "reasonable" service, not perfect service. 220 ILCS 5/9-201. "Reasonable service to all customers does not contemplate a perfect service free of problems . . ." Domestic Utility Services Co., Ill. C.C. Dkt. 81-0515, 1982 PUC LEXIS 10, p. *9 (Nov. 18, 1982).

In this context, Ameritech Illinois notes that it is possible to maintain a record of customers that have been affected by installation and repair delays and by missed installation and repair appointments. (Tr. 1967-68). Therefore, customer-specific credits can, in fact, be conditioned on whether the Company meets the relevant benchmarks and paid to the appropriate customers once the year's service quality data are available.

Next, Staff's and GCI's proposed customer credits for installation and repair delays are excessive, as they are not capped at a level that reasonably approximates the value of the service to be provided. For example, if Staff's proposed $25 per day penalty were applied, without a cap, to a situation in which a customer that experience an extended installation delay as a result of a lack of facilities in the area, the penalty would total $750 over 30 days--far in excess of the value of service (or the cost of obtaining replacement service). This would create a windfall, not reasonable compensation. (Am. Ill. Ex. 3.4, pp. 11-12). Both as a matter of regulatory law and as a matter of general commercial law, compensation should be limited to the value of service. In re Illinois Bell Switching Station Litigation, 161 Ill. 2d 233 (1994). In fact, the ComEd credit program that Ms. Jackson cites as an example is capped at $100, which reasonably approximates the value of service. (Staff Ex. 9.0, p. 21; Am. Ill. Ex. 3.4, pp. 11-12).

Although Staff's Initial Brief (pp. 73-74) is not entirely clear, Staff's position appears to be that Ameritech Illinois should be given the option of choosing whether to provide cash compensation or cellular telephone service in instances of installation or repair delay. Assuming this reading is correct, Staff's proposal at least recognizes that the Company should not be required to pay cash compensation greatly in excess of the price of service (or replacement service). However, the better approach would be to cap customer compensation at levels that reasonably approximate the value of service. Ameritech Illinois has proposed (Am. Ill. Ex. 3.2, pp. 9-10) the following customer-specific credits, which are essentially the same as those currently in place in Ohio:

<u>For 00S>24:</u>

- OOS reports lasting from 24 hours to 48 hours: a pro rata share of the customer's monthly regulated service
- OOS reports lasting form 48 hours to 72 hours: a credit equal to one-third of the customer's monthly regulated service
- OOS reports lasting 72 hours to 96 hours: a credit equal to two-thirds of the customer's monthly regulated service
- OOS reports lasting in excess of 96 hours: a credit equal to one month of the customer's regulated service

<u>For Installation Within Five Days:</u>

- Installations completed within six to nine business days: One-half of the non-recurring installation charges associated with the order
- Installations completed in 10 or more business days: 100% of the non-recurring installation charges associated with the order

Finally, Ameritech Illinois opposes any requirement that cellular telephone loaners be provided in cases of installation delay. As Mr. Hudzik explained, customers that experience installation delays are not paying for service during the delay and therefore need not be compensated for lost service. Moreover, they will typically have an opportunity to make alternative arrangements for service in the interim. Finally, cellular telephone loaner programs impose significant expenses and administrative burdens on the Company; thus, their use should be minimized whenever other means of customer compensation are available. (Am. Ill. Ex. 12.1, pp. 32-33).

d. <u>Other Issues</u>

<u>Wholesale Issues.</u> Staff and McLeodUSA contend that the Commission should address wholesale service quality in this proceeding by ordering that the provisions of Merger Condition

30 survive as part of the Alternative Regulation Plan. (Staff Init. Br., pp. 67-68; McLeod Init. Br., pp. 11-12). In the alternative, McLeod USA states that such issues should be addressed "in the proceeding relating to Condition 30 of the order approving the SBC-Ameritech merger, Docket 01-0120, or another docket that is focused on this specific topic." (McLeodUSA Init. Br., p. 12).

The Commission should adopt McLeodUSA's alternative proposal and should address wholesale issues in another, more appropriate forum. First, as McLeodUSA notes, Docket 01-0120 is already underway, with the express purpose of addressing Merger Condition 30. Second, wholesale service quality can be addressed in a variety of proceedings far more appropriate to that purpose, including the negotiation and arbitration process, rulemaking proceedings and others. Third, and closely related, the record in this proceeding contains very little evidence concerning the measures, benchmarks, and remedies most appropriate for carriers. Many of the retail measures at issue here are completely unrelated to wholesale service. And finally, CLEC participation in this docket has been minimal; thus, any broad ruling on wholesale issues might well prejudice carriers whose views have not been heard.

V. <u>THE "REVENUE REQUIREMENTS" ANALYSES OF GCI AND STAFF GROSSLY OVERSTATE THE COMPANY'S EARNINGS</u>

A. <u>REVENUE AND EXPENSE ADJUSTMENTS</u>

1. <u>Depreciation Expense</u>

Under the terms of the 1994 Order, Ameritech Illinois assumed the full risk of capital recovery -- i.e., it would forego its legal right to increase subscriber rates needed to guarantee full recovery of its assets -- in return for the right to set its own depreciation rates and to recover its investments within the constraints of the price index. <u>1994 Order</u> at pp. 54-55. As the

Commission expressly found, this capital recovery freedom is an "integral part" of the Plan. Id. at p. 55. GCI and Staff, however, have each made proposals to eliminate from 1999 operating expenses significant amounts of the depreciation and amortization expense which the Company actually incurred in the reasonable exercise of its capital recovery freedom. As discussed below, if rates are "reinitialized" on the basis of these proposals, the effect will be to negate the Company's capital recovery freedom and abrogate the regulatory bargain which underlies the Plan. Those proposals should be rejected.

a. Response to Staff

In its testimony and exhibits, Staff took the position that the appropriate level of depreciation and amortization expense (not taking into account Staff's proposal to eliminate the FAS 71 amortization) is \$606.108 million, an amount only slightly less than the adjusted level of depreciation expense (\$607.758 million) proposed by the Company. (Staff Ex. 24.0, Sch. 24.1; Staff Ex. 30.0, Schs. 30.1, 30.2). In its Initial Brief, Staff has changed its position, and now "recommends" a depreciation expense figure of \$558.681 million based on an "analysis" presented for the first time in its Initial Brief. (Staff Init. Br., p. 98, App. B, p. 1).

In arriving at its new number, Staff, for the first time in this proceeding, proposes to disallow \$32.1 million of "Other Freedom" amortizations. (Staff Init. Br., p. 99). As discussed in the Company's Initial Brief (p. 101), this amount represents the annual amortization of a portion of the reserve deficiency resulting from adoption of more realistic depreciation rates in 1994 pursuant to the depreciation freedom granted in the 1994 Order. (Am. Ill. Ex. 7.2, p. 8; Tr. 1074-75). Staff's change in position on this matter is unsupported by any explanation and is directly contrary to Staff witness Green's testimony that, in light of the Company's "freedom of depreciation," he does not "question the total unseparated depreciation figures used by

Ameritech Illinois." (Staff Ex. 24.0, p. 8). Staff's proposal to disallow the "Other Freedom" amortization should, therefore, be rejected.

Staff also proposes (again, for the first time in this proceeding) to disallow the 1999 amortization of analog circuit equipment in the amount of $11.2 million. (Staff Init. Br., p. 99). Staff expresses uncertainty as to whether the amortization of analog circuit equipment has been "accepted" by the Commission. (Id.). As Mr. Dominak explained, a comparison of Staff's proposed level of depreciation expense in Docket 92-0448 (which included the amortization of analog circuit equipment) to the amount approved by the Commission in the 1994 Order indicated that the amortization was, in fact, "accepted" for purposes of establishing the "going-in" rates approved in that proceeding. (Am. Ill. Ex. 7.2, p. 8; Tr. 1169-73). Moreover, even if the amortization had not been accepted for purposes of establishing the "going-in" rates (and it was), the Company clearly had the authority to implement the amortization pursuant to its depreciation freedom. Staff also asserts that the amortization "has expired." (Staff Init. Br., p. 99). The amortization had not, however, expired prior to the end of the 1999 test year. (Am. Ill. Ex. 7.2, p. 8). In effect, Staff is proposing a pro forma adjustment to eliminate an actual expense incurred during the 1999 test year without taking into consideration offsetting post-test year increases in depreciation expense resulting from additions to plant in service. Such additions totaled $788 million during the period from January 2000 through November 2000. (Am. Ill. Ex. 7.1, p. 29).[28]

Staff's new calculation of depreciation expense, as shown on Appendix B to Staff's Initial Brief, is understated for another reason as well. Staff correctly starts with the total depreciation expense amount of $703.705 million shown on Ameritech Illinois Exhibit 7.3,

[28] Based on the composite depreciation rate of 6.3% (Am. Ill. Ex. 1.6, p. 3), the annual depreciation expense associated with these plant additions is $49.65 million.

Schedule 4. This figure was developed by the Company on the basis of corrected jurisdictional allocation factors, as discussed by Mr. Dominak in his Additional Surrebuttal Testimony. (Am. Ill. Ex. 7.3, pp. 2-3). Staff then subtracts an adjustment for "overdepreciated accounts" in the amount of $101.657 million. As Mr. Dominak explained, however, the $101.657 million figure was not calculated in a manner consistent with the jurisdictional allocation factors used to develop the $703.705 million total depreciation expense figure. (Tr. 1088-91). Based on the correct application of those jurisdictional allocation factors, the appropriate adjustment for the "overdepreciated accounts" is $95.948 million, as shown on Ameritech Illinois Exhibit 7.3, Schedule 4. Failure to make the correct adjustment for "overdepreciated" accounts causes Staff's revised level of depreciation expense to be understated by $5.709 million ($101.657 - $95.948).

Staff also reiterates its proposal to exclude the FAS 71 amortization of $108 million from 1999 operating expenses. In support of that proposal, Staff continues to argue that the "Commission found in Docket 92-0448 that no amortization of a depreciation reserve was appropriate for inclusion in an alternative regulatory plan." (Staff Init. Br., p. 97). As the Company has previously discussed, Staff's argument mischaracterizes the 1994 Order, which found only that an amortization of the reserve deficiency at issue in that case should not be included in the revenue requirement adopted for purposes of establishing the "going-in" rates under the Plan. (Am. Ill. Init. Br., p. 94; Am. Ill. Ex. 1.5, p. 11; 1994 Order at p. 133). As discussed below in response to the City of Chicago, amortization of the asset write-down resulting from the discontinuance of FAS 71 is fully supported by the capital recovery freedom granted to the Company in the 1994 Order. (Am. Ill. Ex. 1.5, p. 11).

Pursuant to the condition under which capital recovery freedom was granted, the Company has never sought, and does not now seek, to change its rates, or the price cap formula, to reflect increased depreciation expense over the level included in the "going-in" level of rates approved in the 1994 Order. (Am. Ill. Ex. 1.5, pp. 12-13). Accordingly, there is absolutely no merit to Staff's assertion that, by opposing proposals to reduce rates on the basis of a revenue requirement which excludes FAS 71 amortization (thereby depriving the Company of the opportunity to recover that cost within the constraints of the price index), the Company is somehow making a "second attempt to recover costs previously disallowed for rate making purposes." (Staff Init. Br., p. 97).

For these reasons and the reasons discussed in the Company's Initial Brief (pp. 94-96), Staff's proposal to disallow the FAS 71 amortization should be rejected. Moreover, for the reasons discussed below in response to the City of Chicago's Initial Brief and in the Company's Initial Brief (pp. 128-31), if the FAS 71 amortization is disallowed as an expense, it is imperative that an adjustment be made to the accumulated reserve for depreciation to reflect restoration to rate base of the value of the assets which were written down pursuant to the discontinuance of FAS 71.

b. Response to the City of Chicago

In support of GCI's proposal to reduce the Company's 1999 depreciation expense by over $225 million, the City of Chicago asserts that this proposal "does not challenge the depreciation flexibility granted by the Commission." (City Init. Br., p. 47). This assertion is extremely disingenuous. As its Initial Brief makes clear, the City's position is based on the premise that the level of depreciation expense actually incurred by the Company in 1999 is "unreasonable" because it exceeds the amount of depreciation expense that would be calculated on the basis of a remaining life analyses of the type which are uniquely required by regulators (e.g., development of projection lives, survivor curves, historical analyses of retirements and so forth). (City Init. Br., pp. 49-54).[29] The City's argument ignores the fact that the Company's adoption of depreciation rates and other capital recovery practices which result in depreciation expense levels different from those which would result from depreciation studies of the type espoused by the City is the very essence of depreciation freedom. (Am. Ill. Ex. 1.3, pp. 99-100; Am. Ill. Ex. 1.5, pp. 23-24). If the Commission were to reduce the Company's service rates to reflect a disallowance of depreciation expense in excess of the amount calculated by Mr. Dunkel on the basis of the traditional regulatory parameters, the effect would be to eliminate the Company's ability to recover such expense within the constraints of the price index, thereby negating the Company's capital recovery freedom. (Am. Ill. Ex. 1.5, p. 23).

The adverse effect of the City of Chicago's proposal in this regard is exacerbated by its position that the asset write-down resulting from the discontinuance of FAS 71 in late 1994 should be treated as a one-time event, with the written down assets excluded from rate base, while, at the same time, the annual amortization of that write-down should be disallowed as an operating expense for purposes of "reinitializing" rates. (GCI Init. Br., pp. 54-55). The discontinuance of FAS 71, and the resulting asset write-down, was a direct result of the adoption of the Plan and the abandonment of traditional rate of return regulation. (Am. Ill. Ex. 1.1, p. 104). As previously discussed, the capital recovery freedom granted to the Company (which includes the freedom to manage recovery of the asset write-down, within the constraints of the

---

[29] The City of Chicago erroneously claims that, "using 1999, not 1995, information," GCI witness Dunkel "performed an independent analysis to determine appropriate service lives and other parameters for the 1999 forward looking pro forma test year." (City Init. Br., pp. 53-54). In fact, Mr. Dunkel acknowledged that he developed his proposed level of depreciation expense on the basis of projection lives, survivor curves, and net salvage values adopted on the basis of an analysis performed by the FCC (not Mr. Dunkel) in 1995 (not 1999). (Tr. 1719-20).

price index, through an eight year amortization) was an "integral part" of the Plan. 1994 Order at p. 55. GCI essentially proposes to flow through to ratepayers the entire benefit of the asset write-down and deprive the Company of any ability to recover the cost of those assets. GCI's proposal is confiscatory and should be rejected.

Moreover, the City of Chicago's approach is directly contrary to its position that Ameritech Illinois' earnings under the Plan "must be compared to what would have resulted from rate of return regulation." (City Init. Br., pp. 11-12). If the Plan had not been adopted, and Ameritech Illinois had continued to be regulated under traditional rate of return regulation, the FAS 71 asset write-down would not have occurred, and Ameritech Illinois would not have booked depreciation rates higher than those approved and calculated in accordance with Commission approved remaining life parameters. As a result, the December 31, 1999 intrastate depreciation reserve balance would be approximately $1.7 billion less (and the resulting rate base $1.7 billion more) than the reserve balance (and rate base) shown on Schedule 2 of Ameritech Illinois Exhibit 7.1. (Am. Ill. Ex. 7.1, p. 39). The City, however, proposes to analyze the Company's earnings and reinitialize rates based on a December 31, 1999 rate base which reflects the full impact of the Plan, including the FAS 71 write-down and a higher depreciation reserve (i.e., lower rate base) resulting from the Company's exercise of its depreciation freedom under the Plan. In essence, the City would have the Commission compare results under the Plan to results under traditional regulation, except in those circumstances where the comparison would undermine the City's calculation of its proposed revenue reduction. The City's arbitrary and one-sided approach should be rejected.

The City of Chicago attempts to distract attention from unfairness of its proposal by making a completely unjustified attack on the "expertise" of the Company's witness, Mr.

Gebhardt. (City Init. Br., pp. 46-47). Mr. Gebhardt did not purport to present a depreciation study (with detailed analyses of "projection lives," "survivor curves," and other remaining life parameters) of the type traditionally used to set depreciation rates for rate-of-return regulated companies. Rather, the purpose of Mr. Gebhardt's testimony (which he presented as an expert in the areas of regulation, finance, accounting, and depreciation policy) was to explain why GCI's proposal to reduce depreciation expense on the basis of the traditional regulatory approach espoused by Mr. Dunkel is inappropriate and inconsistent with the purposes of the Plan and the policies underlying the Commission's approval of that Plan. As one who was intimately involved in developing and presenting the Plan in Docket 92-0448, Mr. Gebhardt is eminently qualified to testify as an expert on these matters. Mr. Gebhardt, who has a Bachelor of Arts degree in Economics and an MBA in Finance, was employed for twenty years in the Company's Regulatory Affairs organization, including six years (from 1994 through 1999) during which he was Vice-President -- Regulatory Affairs, a position in which his responsibilities included management of the Company's activities in proceedings before this Commission. (Am. Ill. Ex. 1.0, p. 2). During his years in Regulatory Affairs, Mr. Gebhardt testified before this Commission on numerous occasions, including all of the Company's major rate cases, as well as the Alternative Regulation Proceeding. (Id.).[30]

The City of Chicago further asserts that the Commission "should be especially troubled by the fact that Ameritech eliminated its 'capital recovery' organization responsible for depreciation issue." (City Init. Br., p. 47). As Mr. Gebhardt explained, however, the

[30] Inexplicably, the City of Chicago also attacks the qualifications of the Company's cost-of-service witness Mr. Palmer, even though he did not testify on the topic of the Company's capital recovery practices. (City Init. Br., p. 46). In accordance with the requirements of the 1994 Order, Mr. Palmer applied the depreciation rates approved by the Commission in that Order for purposes of the LRSIC cost studies presented in this case. Accordingly, the fact that Mr. Palmer may not be a "depreciation expert" is completely irrelevant.

organization referred to by the City consisted of a team of experts who relied on complex, expensive models and engaged in very burdensome data collection for the sole purpose of producing depreciation studies required by regulators. (Am. Ill. Ex. 1.3, p. 100). Elimination of unnecessary regulatory functions and the associated reduction in the costs and burdens of regulation are precisely what the Commission contemplated in approving the Plan. (Id., pp. 100-01).

The City of Chicago also reiterates Mr. Dunkel's complaint that the Company did not respond to "repeated requests" for the FCC parameters (such as curve shape (or Gompertz-Makeham parameters), remaining lives and percent reserve) used to calculate depreciation rates. (City Init. Br., p. 55; Am. Ill. Ex. 1.3, p. 106). The Company did, in fact, respond by explaining that it does not rely on FCC historical conventions and parameters in setting its existing depreciation rates. (Am. Ill. Ex. 1.3, p. 106). As previously explained, the Commission, in its 1994 Order, expressly recognized that Ameritech Illinois should not be required to set depreciation rates in that manner. Instead, the Commission has allowed the Company to establish depreciation rates and capital recovery practices on the basis of Generally Accepted Accounting Principles, looking to "economic conditions, competitive market considerations and sound programs of equipment replacement." 1994 Order at p. 55. As explained in the Company's Initial Brief (pp. 97-99), this is exactly what Ameritech Illinois has done.

Finally, it should be emphasized that, even as compared to the depreciation expense amounts which would be calculated on the basis of FCC parameters, the Company's depreciation expense level is not unreasonable. (Am. Ill. Ex. 1.3, p. 105; Am. Ill. Ex. 1.5, pp. 28-29). When the effect of the FAS 71 amortization is eliminated, as it properly should be for comparison purposes, the resulting composite depreciation rate for the Company is 6.3%. (Am. Ill. Ex. 1.6,

p. 3). This rate is virtually identical to the 6.2% composite rate which would be produced by depreciation rates reflecting remaining lives at the low end of the FCC's authorized ranges. (Am. Ill. Ex. 1.3, p. 105; Am. Ill. Ex. 1.6, p. 3).

The City of Chicago makes a number of other arguments, including that (i) there was "no reserve deficiency in 1999;" (ii) the FCC treats FAS 71 amortizations "below the line;" and (iii) "observed" lives are longer than "projection lives." (GCI Init. Br., pp. 51, 53, 54). Each of these arguments is meritless for the reasons fully discussed in the Company's Initial Brief (p. 96, n. 34; pp. 100-01). That discussion will not be repeated here.[31]

2. Directory Revenues

a. Response to Staff

Staff begins its discussion of Directory Services with the incorrect statement that "Directory Revenue is the profit Ameritech Illinois has received from publishing and selling advertising Illinois directories." (Staff Init. Br., p. 98). As Staff well knows, Ameritech Illinois has never published or sold "advertising Illinois directories." (Am. Ill. Ex. 1.3, pp. 112-114; 1994 Order, p. 98). Staff then concludes that the Commission should impute $126 million of Directory Revenue to Ameritech Illinois "to restore the revenues determined to be appropriate for ratemaking purposes as also determined in the original Alt. Reg. Proceeding." (Staff Init. Br., p. 98). However, Staff provides no factual or legal support for imputing revenues in this proceeding. Staff's unprincipled recommendation to impute directory revenues should be rejected.

31 Cook County also addresses the issue of depreciation expense. (Cook County Init. Br., pp. 89-94). Cook County's discussion of depreciation expense is a rehash of arguments made by GCI and Staff to which the Company has fully responded above and in its Initial Brief.